Chapter 4: Outsourcing

Objectives

- Examine outsourcing as a collaborative logistics solution.
- Understand the difference between insourcing, offshoring and nearshoring.
- Examine what e-sourcing is.

1. Introduction

We have defined supply chain in Chapter 1. The concept can be simplified below.

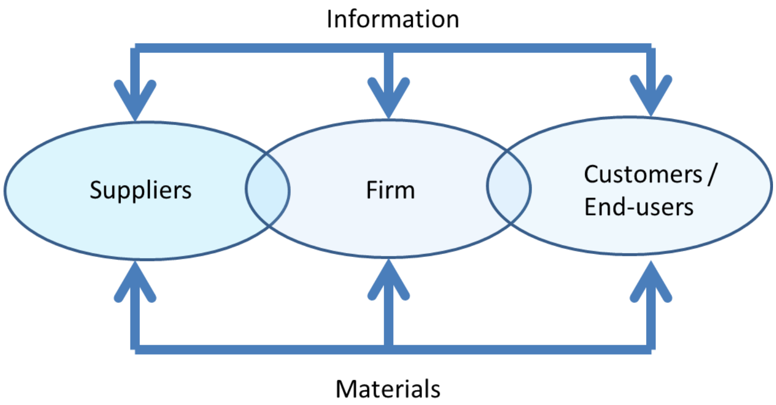

Figure 4-1: Simplified Supply Chain Model

In some industries, the suppliers comprise many tiers such as first-tier, second-tier, third-tier and possibly fourth-tier suppliers. What is constant is the flow of information and materials between the entities in the supply chain.

Likewise, customers could also be grouped into layers such as wholesalers, distributors, retailers and end-users.

All these firms must work towards collaboration and it can work in the form of outsourcing. In Chapter 2, we have briefly covered the process of selection of suppliers. Here, we will discuss the concept of outsourcing and postponement.

2. Insourcing

In recent years, outsourcing has gone through changes and a number of MNCs have reversed their outsourcing strategies to insourcing.

When companies decide to perform a business process itself, it is known as insourcing.

The main aims are to gain what is perceived as:

- Lost transparency & control
- Onerous contractual models
- Lack of competition
- Recurring costs
- Hidden costs

Many MNCs realized that for some countries and some products, outsourcing did not help them reap the lowest total cost as desired. The potential profits were not enjoyed due to the reasons outlined above. Hence, these companies make insourcing a strategy to ensure control, compliance and to gain competitive differentiation.

One method of inshoring is vertical integration.

3. What is Outsourcing?

In business, outsourcing is the contracting out of a business process to a third-party which can be foreign or domestic. Business processes include manufacturing, assembling, packaging, transportation and after-sales services. Eg Dell outsourced its IT after-sales to Philippine call centers.

Outsourcing can operate in one of the following:

- Offshoring
- Inshoring
- Nearshoring

3.1 Offshoring

Offshoring involves shifting work to a foreign, distant organization in order to reduce production costs.

A European IT company may outsource software writing to a company in India, which specializes in such work, to take advantage of low cost, and skilled labor with a common language, but the distance between the two means reduced face contact, therefore less control of the project, and greater vulnerability to threats such as intellectual property theft and fraud.

3.2 Inshoring

Inshoring uses local processes, resources and technologies and adds value not just to the firm's business but also ensures economic and social gains for the area. The advantage is that the business stays within the country.

Inshoring refers to bringing previously offshored contact center functions back to operation centers based in the domestic market.

Inshoring removes some of the risks associated with offshoring. It does not eliminate all of offshoring's challenges, most notably, the dependency on low-cost resources that may result in many of the same cultural, local knowledge and business context limitations.

The benefits of inshoring are:

- Leveraging best business practice in your own area
- Face-to-face discussions in the product development cycle
- Proximity value
- Due to proximity, there is control of quality and schedule
- Removing any kind of cultural and time-zone differences
- Tap local talent

The challenges of inshoring are:

- Local area may not have the talent needed to carry out product development or tax incentives to match overseas markets
- While the language may be similar, cultural differences can be a challenge to overcome for different areas
- Proximity is not the same as accessibility
- There may not be a market where the plant is located

3.3 Nearshoring

Nearshoring is "the transfer of business processes to companies in a nearby country, often sharing a border with one's own country", where both parties expect to benefit from one or more of the following dimensions of proximity:

- Geographic
- Time zone
- Cultural
- Linguistic

- Economic
- Political
- Historical linkages

In Europe, Western European MNCs nearshore their operations to Czech Republic, Hungary, Portugal, Poland, Slovakia, Romania, Bulgaria, Belarus and the Baltic.

In the US, American MNCs nearshore to Canada, Mexico and even to Central and South Americas.

4. Comparing Outsourcing to Offshoring

Offshoring	**Outsourcing**
Offshoring means getting work done in a different country.	Outsourcing refers to contracting work out to an external organization.
Offshoring is often said it is transferring jobs to other countries. Other risks include political risk, language differences and poor communication.	Risks of outsourcing include different interests of clients and vendors, increased reliance on third parties, lack of in-house knowledge of critical business operations.
Benefits of offshoring are usually lower costs, better availability of skilled people, and getting work done faster through a global talent pool.	Usually companies outsource to take advantage of specialized skills, cost efficiencies and labor flexibility.

Table 4-1: Offshoring vs Outsourcing

5. Best Practices of Outsourcing

- **Align the outsourcing strategy with the corporate and supply chain strategy.**

  Companies that compete by offering personalized and high-touch customer service need outsourcing partners that have flexible and agile service delivery models.

  Conversely, companies or supply chain segments within companies that compete on price need lean, operationally efficient and low-cost partners. With many companies operating several supply chains, it's crucial to understand each one before selecting an outsourcing partner.

- **Understand your current capabilities in managing supply chain outsourcing partners.**

Companies need to determine how stakeholders view and engage with outsourcing providers.

Knowing the current level of maturity will help companies understand what type of outsourcing they require as they become more demand-driven.

It also provides insight regarding organizational and inter-organizational models and governance.

- **Understand your core competencies, the market participants and the points of overlap.**

  The major players in the supply chain outsourcing market are expanding their services into each other's turf.

  Knowing what services are core and which ones are not for each service provider is an important factor to consider when deciding the activities to award to an outsourcing provider.

- **Make outsourcing decisions based on strategic and tangible factors, not just cost.**

  Numerous companies that have outsourced a supply chain function such as manufacturing purely based on direct costs have experienced problems later.

  Some companies found that total costs didn't improve as much as anticipated because customer service suffered and quality problems increased after outsourcing.

  In addition to a robust cost-service analysis capability that addresses make/retain versus buy/outsource, companies must incorporate quality, responsiveness, past performance and risk as decision criteria.

- **Understand how corruption and intellectual property (IP) risks differ by country in key outsourcing regions, such as Asia.**

  Such data can be factored into outsourcing decisions, and can be useful when defining policies, procedures and governance for doing business in countries where corruption and IP theft are a greater concern.

- **Establish and maintain a regular flow of data, information and ideas.**

  Data such as inventory levels, customer orders and master data should be visible and shared weekly; data about significant changes should be communicated more promptly.

  Information such as promotion plans, supplier changes or other decisions that will impact the outsourcing partner should also be updated and communicated weekly.

Ideas for improving overall supply chain performance and multitier visibility should be exchanged and discussed at regular intervals by operational and management personnel.

- **Define and track service levels and key performance indicators (KPIs).**

  The service-level agreements (SLAs) and KPIs defined when an outsourcing partner is selected should be linked to key business goals and objectives.

  Companies that align SLAs with key business goals tend to have a more positive relationship with their outsourcing partners and achieve better results.

6. Third Party Logistics (3PL)

6.1 Overview

The 3PL market is currently going through a fundamental redefinition. An increase in the globalization process, the role of IT and a series of acquisitions and mergers, are fast transforming the 3PL industry.

The business models that supported "arms length" relations with customers are no longer attractive or desired. The new focus is on integrated logistics as "one-stop" solutions. There is also a significant migration from asset-based logistics to value-added and integrated contract logistics solutions.

The emergence of the concept of a lead logistics provider (LLP) has brought about higher degree of specialization within the 3PL market. Also the gradual transformation of 3PL players into a 4PL service provider is just about taking shape and promises to be an exciting phase in the logistics services market globally.

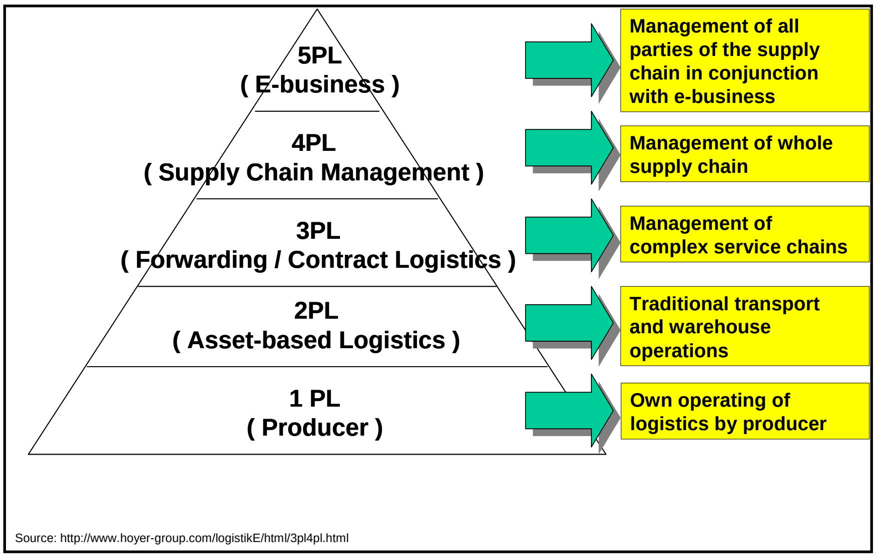

Figure 4-2: Levels of Logistics Outsourcing

6.2 Recent 3PL Developments

The last several years have witnessed the birth of a new breed of contract logistics providers.

Many of these new companies originated in sophisticated logistics departments of large shippers.

These departments found a business opportunity in providing logistics services to other shippers, as well as to their own parent company.

The new breed of third parties can be divided into two main categories – those who own transportation assets and those who do not.

Some providers invest in assets that are used to serve their parent company and then sell the extra capacity in the market place. As these companies grow, they invest in more assets and continue to sell available capacity.

The existing assets are augmented by the use of common carriers – including public warehousing, contract labor, etc.) until the volume and stability of the freight under management justifies further investment in assets.

6.3 3PL Industry Highlights

There is a visible shift from a mere asset-ownership based business model, to a new business process model that seeks to meet the customer demands for integrated end-to-end logistics solutions.

The shift of market focus from national market to trans-European market (take Europe as an example), due to changes in the regulatory environment. The extension of European Union with the new accession states from Eastern & Central Europe further promises to make Europe one of the largest integrated economic regions in the world opening up new opportunities for 3PL players within Europe.

The increased trend towards mergers & acquisitions and alliances between various companies resulting in greater synergies, thereby enabling greater transparency in pricing.

There is an increasing preference among leading manufacturing companies towards the separation of their sales function from that of actual physical fulfillment. This leads to business process outsourcing, creating opportunities for logistics companies to act as Lead Logistics Providers (LLPs).

Industries are realizing the need for outsourcing the management of entire logistics process to a single entity for greater visibility and optimization across the supply chain.

This has led to the emergence of Lead Logistics Provider or 4PL players (to be discussed in subsequent sections). Increasingly 3PL players are pitching for LLP / 4PL services to their clients.

7. 3PL Supply Chain Values

Nowadays most 3PL are capable of providing the following IT system related support and service to customers.

- Shipment and Inventory Tracking
- Cross Dock Management
- Inventory and Warehouse Management
- Key Performance Indicators
- Customer Relationship Management
- Vendor / Supplier Management
- Return Material Authorization
- Transportation Planning and Scheduling
- Order Fulfillment

8. Advantages of 3PL Outsourcing

There are many advantages of outsourcing logistics operations to reliable 3PLs because of the following reasons.

- **Cost Reduction** – these costs can be labour, facility cost, system related cost, logistics cost, etc. Through engaging 3PLs for their services such costs can be reduced especially in the areas of inventory holding cost, warehousing, transportation, customs and duties, etc.

- **Non-Core Business** – if a company is a supplier of telecommunications product, it may not want to own a traffic department to manage its distribution, logistics, etc., as this is not a core business but rather a support function for its main business.

- **Leverage on 3PL's Logistics Network** – through business expansion, most 3PLs have offices and presence regionally and the bigger ones could have logistics network that span globally if not across a few regions.

- **Cut down Asset Investment** – most 3PLs have assets such as facility, trucks, information systems that can be offered as part of the services to customers. From the customers' standpoint these are non-core assets and there is no need to own them if 3PLs can provide such supports readily and cost effectively.

- **Improve Customer Service** – nowadays 3PLs can provide value-added services like packaging, labeling, palletizing, consolidation, deconsolidation, quality control, inspection, merge-in-transit, inventory management, etc.

- **Short Lead-time** – in terms of customer delivery, by leveraging on 3PL's extensive and excellent logistics infrastructure network, the lead-time for transportation and delivery can be improved.

- **Flexibility of Business Expansion and Reduction** – owing to 3PL's extensive and excellent logistics infrastructure network, customers can leverage on the 3PL's capacity to expand their business in times of increasing demands fairly quickly as well as cutting their business with 3PL when demands are lower.

9. Disadvantages and Issues of 3PL Outsourcing

Certainly there are benefits to be reaped when companies outsource their logistics operations to 3PLs however there are disadvantages and issues in terms of 3PL outsourcing.

- **Span of Control** – although the market for contract logistics will continue to grow, the loss of control and service quality issues are the primary constraints to increased 3PL usage.

- **Basic Services** – the offering of value-added services and information management may be the keys to differentiation, but 3PL revenues continue to be still largely generated by basic services.

- **Pricing** – the price of services offered is an important issue in the choice of 3PL providers; lower cost is still the main driver for outsourcing.

- **Limited Choices of 3PL** – As users retain fewer 3PL providers, 3PL service offerings will need to expand directly or through alliances.

- **Confidential Information Sharing** – due to close working relationship, information such as number of order per period may have to share with 3PL in order to support the business from time to time.

- **System Integration** – inadequate 3PL capabilities can result in strain relationship between 3PL and shipper if there is a need to integrate systems to allow information flow.

- **Disparate Expectations** – 3PL and shipper can have different expectation in terms of service level requirements and measurements and such differences if not communicated properly can result in poor service by the 3PL.

- **Implementation Timeline –** when 3PL and shipper forged a partnership, there is a time period for 3PL and shipper to involve in the implementation planning and execution. This period of time allow both 3PL and shipper to understand its operations regimes and sometime the implementation timeline can be relatively long especially if the scope of the agreement is more extensive.

10. Conclusion

The chapter discusses the stances firms may adopt when determining whether to purchase materials and services from suppliers or to produce them in-house. These concepts of outsourcing, insourcing, offshoring and inshoring have been explored.

Finally, postponement is one strategy which a collaborative supply chain can adopt in order to produce goods at the generic level and then modify them to specific customers' requirements upon receiving their demands.